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THE REA CAPITAL CREDITS PROGRAM

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Nobody is opposed to ordinary neighborly cooperation. Perhaps the word "cooperation" has become too strong a term for the old form of American neighborliness, expressed in a number of practical ways -- especially as an important factor in rural life and economy. Barn raisings and joint-harvesting efforts are still looked upon as typically "American."

But in recent decades the word cooperation has taken on a collectivist connotation. Spontaneous cooperation has been replaced in the popular mind by organized cooperation via the "cooperative" form of enterprise. When Soviet writers use it (and they use it often, because the "cooperative" form is an important adjunct of Soviet economy) they mean something quite different from the American concept. But even our American concept has become confused by specialized applications. These in turn run the gamut from simple rural marketing and purchasing groups, through the REA variation, to the million-dollar superproduction jobs which have been criticized as out-and-out tax-dodging devices.

This largely tax-exempt institution is regarded by some as not quite conciliable with "fair play" and "healthy competition." To social reformers, looking at the social results obtained for immediate co-op members, all means to that end are sympathetically viewed and morally rationalized.

Co-ops, including the rural electric co-ops, are not necessarily "infant industries" which need protection in order to mature and then serve the greater common interest. That thought has not been a part of the cooperative plan or its basic concept. Many co-ops which had small and laudable beginnings, based on real neighborhood need, are now huge thriving concerns with all the physical characteristics of successful business enterprises. In addition, they also have had privileges and advantages bestowed upon them by the Federal government while sharing only part of a commercial corporation's public duties and responsibilities.

It is interesting to examine, in light of this, a program fostered by a Federal agency which frankly encourages small economic institutions to retain the co-op form. Conversely this program discourages (if it does not practically prevent) that unit from even becoming a small typical business enterprise, subject to the same stresses and strains (including regulation by government) as its "competitors" or similar privately owned business operations in the same area or similar environment.

The program referred to is the co-op Capital Credits Plan which has been designed and fostered by the Rural Electrification Administration, under auspices of the United States Department of Agriculture. Avoiding the controversial question of "when is a profit not a profit?" -- let us examine other characteristics and implications of the plan.

"The essence of the plan," says an REA circular pamphlet, dated November, 1946, "is an agreement, with the legal form of a contract between the cooperative and its members that any money paid in by the patrons above the cost of serving them is paid in by them as capital. Each patron will get it back eventually when the co-op has accumulated sufficient capital to insure its financial stability."

The ostensible advantages of the Capital Credits Plan for the co-op members are (1) to build up an equity interest for the co-op patrons in proportion to their patronage, (2) to strengthen the sense of personal interest of the members in the local ownership and management of the business, and (3) to provide some incentive for more patronage in the form of eventual return credits as cash to the patron.

But somewhat more critically viewed the Capital Credits Plan can accomplish the following objectives:

(1) Immunity to taxation. The co-op's receipts, over operating expenses and loan requirements, would not be refundable as ordinary "profits" or "income"; but instead sewed up -- by agreement -- in the form of "Capital Credits" to patrons. This would insure income tax exemption, even though Congress should some day change its mind about the tax exemption which co-ops presently enjoy.

(2) Immunity to liquidation of the cooperative. The plan would make it less attractive for a private power company to buy out co-ops because co-op members would no longer sell out their systems for the unpaid balance of the government loans. They would be bound by contract also to liquidate a total in the amount of "Capital Credits" entered on the books in favor of the individual patrons (whether members of the co-op or not).

(3) Immunity to public regulation. To the extent that co-ops enjoy immunity from regulations by public service commissions (as is the case in most states), the retention of the co-op form -- through the operation of the Capital Credits Plan -- would be correspondingly assured.

(4) Immunity to profit incentive. The Capital Credits Plan starts out fresh on the basis of actual patronage -- regardless of whether the patron is a co-op member or not, or how long he has been a patron. Under the plan, older members find themselves bound by contract to honor Capital Credits accumulated by more recently attached patrons. Furthermore, Capital Credits would only accumulate during the years in which the co-op is operating in the black. Any deficit operation would not be deductible from existing credits. Deficits would be charged to co-op operations as a whole.

The plan guarantees that local power consumers will become "contributors of capital" with the avowed purpose and hope that this will act as insurance against the electric co-ops falling into the hands of a public utility company. Adoption of the plan confirms the cooperative form of organization upon the REA co-op -- in advance of its being weaned from REA -- and virtually obliges the group to retain the co-op form.

This brings up an interesting question. Why is an agency of the Federal government so interested in stamping the nation's rural electric service agencies with the cooperative form? Should the REA, which claims to be only a "lending agency," care what form a given enterprise takes, once it has repaid its debt to the Federal government? What if these organizations were left to determine their own future -- after REA? Some co-ops might conceivably be interested in reorganizing as local small businesses. Of course, dropping the co-op form in favor of incorporation would mean, in most cases, that the unit would come within the jurisdiction of the state regulatory commission. It would also lose a number of other privileges conferred upon co-ops by government, certain tax advantages to name one. Or to name another, statutory "preference" in the purchase of public power or surplus property from the Federal government.

Let's assume, however, that farmer co-op members in a certain area might wish to get out of the electric business by handing it over, for value received, to a regular commercial power company. Without the plan, this could happen at any time, either before or after its indebtedness to REA has been paid off. After the co-op has adopted the plan, it would then pose additional obstacles to be overcome, before any sale or transfer of property could be made.

What was the origin of this co-op Capital Credits Plan? Legally speaking, the plan is based on a 1910 precedent established by three railroad companies which decided to build and maintain a railroad bridge across the Ohio river (Paducah, Kentucky, to Metropolis, Illinois) for their joint use. The three railroad companies contributed to the upkeep in proportion to their traffic over the span. But how about an excess, above operating expenses? Would it become a profit, to be taxed against each contributing road? Or could it be viewed as a <u>pro tanto</u> reimbursement of capital?

In the tax appeal case of the Paducah & Illinois Railroad Company (2 BTA 1001) which was determined by the U. S. Board of Tax Appeals in 1925, the court ruled that any such accumulation of funds, resulting from the agreement, was in fact a "capital investment." This convenient precedent was used by REA's legal staff as a solution to the problem of providing co-ops with a program for accumulating capital funds out of operating receipts -- funds which would be immune from taxation as "profits," even if Congress should ever repeal the present income tax exemption enjoyed by co-ops -- as small business interests are even now demanding. The REA circular admits as much when it states:

> "Because the true surplus of a business is taxable income, some critics of co-op enterprise look upon balances over expenses of cooperatives, even if earmarked for return to patrons, as though they were taxable surpluses. Under the Capital Credits Plan there can be no such confusion because of payment."

The ordinary (non-REA) consumer's cooperative requires a relatively small capital investment in proportion to its annual earnings, therefore it can afford to grant dividends on any accumulated surplus. The REA electric co-op, however, requires a high capital investment in proportion to annual earnings. Payments by patrons in excess of co-op costs cannot be returned to the patrons immediately in the form of refunds. REA argues, since they must be applied to the reduction of the REA loan. Using this basis, any payments made by REA co-op patrons in excess of the cost of service are considered to be "capital" supplied by the patrons.

Where they have not already done so, REA electric co-op members are now being urged at their local meetings to adopt the Capital Credits Plan. Such adoption basically involves an agreement between the co-op and its members -- with the legal force of a contract -- which releases the co-op management to use, as investment capital, any funds left over after the actual cost of service has been subtracted from rates charged for service. Thus, the older or founding members, who have seen the co-op through its earlier and perhaps leaner years, surrender their rights as owners to future income in excess of expenses, and agree by mutual consent to turn it over to future patrons (including themselves) but on the basis of future patronage.

REA pamphlets on the plan say: "We strongly recommend adoption of the plan by REA co-ops. REA lawyers have studied the plan with great care and should take credit for the basic framework as well as for working out the fundamental details. The plan is also in keeping with co-op principles and is recognized as sound co-op practice.... We have been in very close touch with other co-op programs...and find them fully consistent with this plan."

This is in line with Agriculture Department theory and practice. Claude R. Wickard, present REA Administrator, and former Secretary of Agriculture, says the co-op form is preferred -- not through any desire to promote cooperative philosophy -- but because his department has found "historically" that it is the only form which can be depended upon to deliver the goods, and do the job of area coverage, as opposed to the selective coverage of the private utilities.

The mechanics of the adoption of the REA "Capital Credits Plan" by a power cooperative requires amendment of the cooperative's bylaws. This, in effect, confirms the cooperative character upon this type of setup. Ostensibly, the amendment is required to enable the cooperative management to divert the surplus of revenue over cost as "capital" from the members as owners, who would otherwise be entitled to it as income of "refunds." In an ordinary consumer co-op, such surpluses would be paid to the members in the form of a rebate.

All patrons of an electric co-op (new and old) participate fully in the plan. This is designed to encourage new members and nonmember patrons in the area to go along with the co-op nature of their power supplier. The charter members who have pioneered the co-op are reassured by REA that they are not being assessed individually for any operating deficits the co-op may have incurred during its first years. They are reminded that they were actually getting service below cost then, and that they cannot expect credit for capital in years when no capital was furnished. They are rather frankly told that they have assumed no risk -- that all the risk was taken by the Federal government which supplied the needed funds through the REA.

In this comparison of members' rights with patrons' rights, it should be remembered that members alone can participate in running the co-op's affairs, in electing its directors, and establishing its policies. Nonmember patrons have no share in the control over the co-op, and no voice in its policy council. But they are entitled to credit for any "capital" which they furnish.

Some enthusiastic REA co-op members with an eye to organizational betterment have suggested that the capital credit of nonmember patrons be used as a down payment on that patron's membership dues in the co-op. REA frowned officially on this device as being obviously undemocratic. It states: "... remember you can't make a man a member without his consent...it is much better for the co-op if he has, and expresses -- by paying $5 out of his pocket -- a desire to become a member."

Now let us examine these credits: These credits represent the amount of money furnished by the member during a specific year (as said heretofore) in excess of the cost of service. What would the co-op do with it, under the plan? Instead of refunding this money as the ordinary farmer co-op would, the REA co-op could use it to pay (1) interest on its debt to the Federal government; (2) as working capital; (3) repayment of loans ahead of schedule; and (4) replacement of or expansion of plant or to meet any other legitimate capital need. After that (i.e., if the money isn't still needed for any of these things), liquidation or repayment of outstanding capital credits could proceed in accordance with the decision of the co-op management.

Under the plan, each member or "patron" gets "capital credits" in proportion to his payments for electric service during the year. If a co-op has received from all of its patrons $100,000 in payments of electric service, and if the cost of providing the service was only $90,000, then 90 per cent of every bill paid is applied to the cost of electric service and 10 per cent is listed as patronage capital. Therefore, a patron whose service bills total $200 will be credited with $20 on his patronage capital account. A patron whose electric bills total $60 will be credited with $6 on his patronage capital account on the co-op books.

Maintaining the plan requires a certain amount of bookkeeping by the co-op management. The manager sets up an account for each patron. Each year the "surplus" capital is credited to that patron in his capital account and he is notified of his contribution. Where the plan is well established, the co-op issues a certificate which represents the amount which the patron has "invested." These certificates are non-interest bearing and they never lose or pick up value. REA says the certificate represents a "specific personal equity in the physical properties of the co-op." Because of the uncertainty of co-op policy the certificate might, in a sense, be viewed as representing theoretical intention to refund the money some time in the distant future.

These certificates, according to the plan, would be retired serially, when the entire indebtedness of the co-op has been wiped off the books and there is sufficient surplus still coming in to guarantee that members' and patrons' contributions can be paid off.

There are many factors that may delay this eventual payment. No patronage capital can be retired until the co-op has obtained enough money to take care of its needs and in the meantime REA encourages the co-op to make new loans to "heavy up" the lines or expand coverage. If a co-op has had heavy operating deficits in some years, it will, of course, take longer for the co-op to reach the point where it can begin to retire patronage capital.

In its folder on the plan, REA says: "Of course, it will be a long time before an REA co-op can begin to pay back any of the capital furnished by its patrons." From the same pamphlet, one co-op member asks, "Can I look forward to getting any large sums of money when my capital credits are retired?" REA answers, "Probably not, if your co-op is efficiently managed." The explanation follows to the effect that the capital credits account may function in a manner similar to the "barometer funds" of certain public utilities.

The question arises, and it is largely a matter of policy of the individual co-op, whether the co-op will see fit to accumulate receipts in excess of expenses and fixed costs and, therefore, many capital credit entries, or whether it will just cut rates to conform more nearly with the cost of power. One possible use of large reserves is their possible application to expand the co-op service area through acquisition of neighboring utility service units, private or municipal. There is also the question whether some of these funds may be used for "educational programs" which are considered perfectly in order in the cooperative movement.

REA strictly avoids any association of the word "stock" in reference to the capital credits plan. Or, any suggestion that the co-op might need this extra "shot in the arm" in order to maintain its operations and repay its debt. REA praises the co-ops generally and states that they are "doing better than was initially expected." REA's pamphlet on the plan also stresses the angle that patrons are thus building up local ownership in the co-op properties while it is paying back the government loan.

Only in the case of over-all liquidation would a co-op's operating deficit affect the value of its patron's capital credits. As long as the business is a going concern, the entries in the individual patron's account show what they will get when, and if, the time comes to retire the capital provided in any particular year or years. On the balance sheet, the net worth section might have an item called "capital credits" but the amount listed there would not necessarily be the sum of those credits if there had been any operating deficits.

In summarization, let us recount the functions of the Capital Credits Plan. First, it preserves the co-op entity and provides a nest egg for expansion. Second, it provides use of what would ordinarily be called "earned income" as capital without the onus of the terms "surplus" or "profit." Third, it may save the co-op from the need for applying to a private institution for a private loan at a high rate of interest. Additional REA loans would not be thus inhibited. Fourth, it provides financial insulation from any attempted merger or acquisition move by a public utility company.

About 25 per cent of all REA co-ops have adopted the plan. Some of the first started in 1941. REA contends that the plan has not been designed for the benefit of the government. It is true that the government's investment is better protected. It is also true that REA has through the plan laid the foundation for perpetuating the co-ops indefinitely. REA is well aware of the fact. The covenant between the members agreeing to the Capital Credits Plan, and the public referendum needed before the plan can be dropped (assuming that the financial condition of the cooperative will permit it), virtually guarantees the continuance of the co-op form.

Just how the REA can justify Federal government encouragement of a form of enterprise which must thrive on tax avoidance and the avoidance of regulation and other rules of business, which the nation's regular commercial system of private enterprise must obey, is not so clear.

It is not mere "indoctrination" that strengthens the co-op members against any desire to sell out or turn into full tax-paying members of the commercial community in which it operates. There is still that leverage which is contained in its tax and other advantages. The plan represents an added incentive to communal ownership in which real ownership is so dispersed and indefinite that it has little meaning. This will persist, even assuming eventual retirement of all capital loaned by patrons, which is akin to the social millennium.